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**COMMONWEALTH OF VIRGINIA**  
**STATE CORPORATION COMMISSION**

**CASE NO. PUA980031**

**(CORRECTED COPY)**

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**BELL ATLANTIC CORPORATION AND GTE CORPORATION  
FOR APPROVAL OF AGREEMENT AND PLAN OF MERGER**

February 26, 1999

## **DISCLAIMER**

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## **OVERVIEW**

Under the Utility Transfers Act of the Code of Virginia, the State Corporation Commission may not approve the disposition or acquisition of assets such as that proposed by Bell Atlantic Corporation and GTE Corporation unless it is satisfied that adequate service to the public at just and reasonable rates will not be impaired or jeopardized. It is the Staff's position that the Petitioners have not met their burden of proof showing that this proposed merger will not impair or jeopardize service to customers of their Virginia subsidiaries, Bell Atlantic-Virginia, Inc. and GTE South, Inc. Therefore, the petition as filed should not be approved. The Petitioners did not sufficiently demonstrate (1) that the GTE LCP interLATA routes will be maintained and (2) that no customers will be harmed by the merger. The Staff's pending motion suggests the Commission may find the application incomplete and require the Petitioners to supplement their filing.

The Commission could, of course, choose to proceed with the petition without having the Petitioners correct the deficiencies outlined above, however, it should do so under the following conditions:

- (1) Petitioners should provide to the Commission prior to the merger proof of appropriate regulatory approval or other concrete assurance from the FCC that the GTE LCP interLATA routes will be maintained.
- (2) At least half of the net jurisdictional savings from the merger should benefit Virginia customers.
- (3) Petitioners should provide to the Commission prior to the merger a ten-year projection of all Virginia costs and savings associated with the merger. Petitioners should then track the actual costs and savings from the merger and true-up the ten-year projection, if necessary, one year after the merger is consummated.

- (4) The Commission should extend the cap on BA-VA's Basic Local Exchange Telephone Services for eight years until the year 2009 to mitigate the anti-competitive effect of the merger. Eight years will encompass the three years projected for net savings to accrue and a reasonable period of five years to benefit customers.
- (5) The Commission should require that any affiliate agreements between BA-VA and GTE South be filed by both Petitioners for prior approval. Current exemptions should not include agreements or arrangements between BA-VA and GTE South affiliates and transactions between GTE South and BA-VA affiliates.
- (6) Consistent with previous Commission actions, the BA-VA and GTE South calling plan announced on February 4, 1999, should be subject to a separate proceeding, and the Petitioners should be required to look beyond contiguous exchanges in order to incorporate additional calling between exchanges with high communities of interest.
- (7) The local service rates of GTE South's Southwest exchanges should be reduced to more accurately reflect those in nearby comparably sized BA-VA exchanges and other comparably sized GTE South exchanges.
- (8) All Class services should be available to all customers in GTE South exchanges by a date certain of no later than one year from the effective date of the merger of Bell Atlantic and GTE.
- (9) BA-VA should not be permitted to consolidate its Virginia business office operations in Virginia with those of GTE or move them outside of Virginia without Commission approval. In addition, the Petitioners should be encouraged to develop a plan to handle all business office inquiries for both BA-VA and GTE South customers in a manner consistent with current BA-VA practices.
- (10) The Commission should order BA-VA and GTE South to send appropriate notice of any accounting changes, including the dollar impact of the changes, to Public Utility Accounting at least ninety days prior to the effective date.

- (11) Petitioners should individually be required to report specific data to Staff regarding the CLECs that each is interconnecting with and/or providing resold lines to, as evidence of the change in the market. This data could be provided through the same or similar report as was provided by BA-VA in response to Staff Interrogatory 7, First Set.

The Staff believes the imposition of these conditions is necessary to assure that the requirements of the Utility Transfers Act are met.

## **PART A-DIVISION OF PUBLIC UTILITY ACCOUNTING**

### **Summary of Application**

On October 2, 1998, Bell Atlantic Corporation (“Bell Atlantic”) and GTE Corporation (“GTE”), collectively referred to as “Petitioners,” filed a joint petition (“the petition”) with the Commission under the Utility Transfers Act. In the petition, Bell Atlantic and GTE request approval of a transaction that will result in GTE becoming a wholly owned subsidiary of Bell Atlantic. Bell Atlantic and GTE are the parent companies of Bell Atlantic-Virginia, Inc. (“BA-VA”), and GTE South, Inc. (“GTE South”), respectively. BA-VA and GTE South both are authorized to provide, and are providing, local exchange and intraLATA toll services in Virginia. Neither Bell Atlantic nor any of its affiliates, including BA-VA, are currently affiliated with GTE or GTE South.

As represented by Petitioners, BA-VA and GTE South will continue to provide services as separate legal entities after the merger. The merger will be at the parent company level, not at the subsidiary level. Petitioners further represent that BA-VA and GTE South will continue operating under their respective regulatory plans. BA-VA is currently regulated under the terms of the Bell Atlantic-Virginia Plan for Alternative Regulation adopted by Final Order in Case No. PUC930036, and GTE South is regulated under the terms of the GTE South Alternative Regulatory Plan adopted in the same Final Order in 1994. Petitioners represent that the merger will not affect the Commission’s ability and authority to regulate BA-VA and GTE South.

In the petition, BA-VA and GTE South represent that the merger will not jeopardize the provision of adequate service to the public at just and reasonable rates or adversely affect the Commission's authority over those rates and services. Petitioners represent that the merger will enhance the abilities of both companies to satisfy their customers' requirements for service by capitalizing on the best practices of both corporations and on the other synergies the merger will provide. Petitioners also represent that the merger will have no adverse effect on competition in Virginia. They represent that both companies remain committed to opening their markets to local competition, consistent with the requirements of the Telecommunications Act of 1996 and rulings of the Commission. Bell Atlantic and GTE state that the combination of Bell Atlantic and GTE will position the companies and their affiliates to provide a complete array of facilities-based voice, data, and Internet services in competition with other providers more quickly than would otherwise have been possible.

Bell Atlantic has its headquarters in New York. As indicated in the petition, through its subsidiaries, including BA-VA, Bell Atlantic has more than forty million access lines in service across fourteen jurisdictions from Virginia to Maine. On the other hand, GTE's headquarters are in Irving, Texas. As indicated in the petition, through its incumbent local exchange ("ILEC") subsidiaries, including GTE South, GTE has more than twenty-two million access lines in service across twenty-eight states (including portions of Virginia). Also as indicated in the petition, through its subsidiary, GTE Communications Corporation ("GTECC," formerly known as GTE Card Services, Inc., d/b/a GTE Long Distance), also provides, or is authorized to provide, long distance, operator, and pre-paid calling card services on a resold basis in all fifty states.

BA-VA is a wholly owned subsidiary of Bell Atlantic. It is an incumbent local exchange carrier authorized by the Commission to provide both local and intraLATA toll services throughout portions of Virginia, including Richmond, Hampton Roads, and Roanoke and the Virginia portions of the Washington, D. C. metropolitan area. It has approximately 3.4 million access lines in service.

GTE South is a wholly owned subsidiary of GTE. It also is an incumbent local exchange carrier authorized to provide local exchange and intraLATA toll services throughout portions of Virginia, primarily including several sparsely populated rural areas. In 1994, it completed a merger with Contel of Virginia through which GTE South continues to provide service in the old Contel territories. GTE South has approximately 557,000 access lines in service in Virginia.

Bell Atlantic and GTE have executed an “Agreement and Plan of Merger” (“the Agreement”). Pursuant to the Agreement, GTE will become a wholly owned subsidiary of Bell Atlantic. As a result, ultimate control of GTE South will transfer to Bell Atlantic. Control of BA-VA will remain unchanged following the merger since it will continue to be a wholly owned subsidiary of Bell Atlantic.

According to the Agreement, GTE shareholders will receive 1.22 shares of Bell Atlantic stock for each share of GTE stock they own. No bonds, notes, or other forms of indebtedness will be issued to finance the transaction, and no approvals to issue such indebtedness are requested in this petition. The transaction is expected to be tax-free to shareholders and will be accounted for as a pooling of interests. At the time the petition was filed, Petitioners represented that the merger had been approved by the boards of directors of each company but had not been voted on by the stockholders. Petitioners

state that the combined company, based on 1997 pro forma financial analysis, will have revenues of \$53 billion and assets of approximately \$96 billion.

Petitioners state that the headquarters for the combined company will be in New York City. The combined company's board of directors will have equal numbers of directors designated by Bell Atlantic and GTE, and the top management team will be a blend of the senior managers of both companies.

Petitioners state in the petition that, while the merger will change the identity of the corporation ultimately owning GTE South, it will not involve any immediate change in the manner in which either GTE South or BA-VA provides services to customers.

With respect to the operations of GTECC as a reseller of long distance service in Virginia, Petitioners state that those operations will continue until the time the merger is consummated. Petitioners represent in the application that, if Bell Atlantic has not obtained permission under Section 271 of the Telecommunications Act of 1996 to provide interLATA long distance service in Virginia by that time, the combined company will request transitional relief from the Federal Communications Commission ("the FCC"). Petitioners further represent that the merger is not expected to have a material impact on employment levels of Bell Atlantic Associates or GTE hourly employees, and that all existing union contracts will be honored. Petitioners also represent that, in the long term, it is anticipated that the merger will generate more job opportunities by positioning the companies to compete more effectively in the telecommunications market. Petitioners further state that, while it is expected that some redundant management positions, principally in staff organizations, may be consolidated over time, any consolidation is expected to be accomplished, to the extent possible, by attrition,



retirements, and other voluntary measures. Petitioners expect that the merger will create new professional opportunities in the combined company.

As indicated in the petition, Bell Atlantic and GTE are merging because together they can better serve existing and new customers than either company could alone in the rapidly, changing competitive market. Each company also wants to ensure that, in the face of competition, it can remain a strong, healthy provider of telecommunications services in its current territories with the ability to accelerate deployment of advanced services to its customers. In addition, each company wants to be a fully integrated telecommunications service provider, able to offer residential and business customers local and long distance voice, data, video, and wireless services.

Petitioners represent that the merger between Bell Atlantic and GTE, whose affiliates serve adjacent but distinct areas in Virginia, will allow the companies to build on their strengths and offer additional benefits to the public in a variety of ways. It is further stated that the merger will result in a larger, more efficient company with increased financial strength. Petitioners state that the combined company will be able, nationally, to reduce overall expenses by \$2 billion within three years of closing through such means as greater purchasing power, the elimination of redundant systems, and reduced corporate overheads. Petitioners further state that these savings will help contain cost pressures across the company, freeing resources for investing in new services, enhancing service quality and competing more effectively against the other companies that have recently been involved in mergers.

Another benefit of the merger, as represented by Petitioners, is that the combined company will be able to draw upon the expertise and abilities of personnel from both

companies, adopting the best practices of each in order to better serve the public. Petitioners also refer to recent mergers of major national and global competitors that have created a number of facilities-based carriers capable of providing a complete package on one bill of all services customers increasingly demand (local and long distance voice, data, video, and wireless). Petitioners represent that the merger between Bell Atlantic and GTE will give the combined company a scale and scope to compete with other companies head-to-head in local, national, and international markets, and the ability to offer a more complete package of services to customers.

Bell Atlantic and GTE represent that other benefits of the merger include the following: stronger combined companies will be better-positioned to continue their records as responsible corporate citizens throughout Virginia, the greater financial strength and stability of the combined company will position it to better preserve and advance each company's commitment to universal service in Virginia, and the merger will increase the competitiveness of the telecommunications market in Virginia to the public's benefit. Petitioners further indicate that the merger also will create more facilities-based competition in the long distance market.

In further support for the merger, Petitioners represent that the merger will have no adverse effect on competition in the local exchange market by eliminating any potential competition between GTE South and BA-VA in each other's territory. Petitioners state that, even without the theoretical possibility of competition between BA-VA and GTE South, dozens of competitors remain in the local exchange market. They indicate that, in Virginia, there are fifty-seven competitive local exchange carriers certified to provide service, including several companies providing facilities-based

competition. They also state that the loss of one potential competitor in this instance is not competitively significant. They further state that, in any event, the advantages the merger offers both companies will provide customers benefits far outweighing any slight loss of potential competition from one additional company.

An order extending the period for Staff's review and the issuance of a final order in this case was issued by the Commission on October 23, 1998. That Order also provided an opportunity for public comments and requests for hearing and required that Petitioners publish notice. On November 20, 1998, the Commission issued an Order Extending Deadlines for Petitioners to provide public notice, and for public comments and requests for hearing to be filed with the Commission. GTE filed Proof of Notice on December 14, 1998, and Bell Atlantic filed Proof of Notice on December 14, 1998, and December 22, 1998.

A Protective Order governing procedures with respect to confidential information was issued on December 17, 1998. On January 7, 1999, the Commission issued its Order Granting Extension of Time for AT&T Communications of Virginia, Inc., ("AT&T") to file its comments. On January 29, 1999, the Commission issued its Order Extending Date for Filing Supplemental Comments to allow AT&T additional time for filing its supplemental comments. On February 8, 1999, the Commission issued its Order Granting Further Extension of Time to File Staff Report and on January 14, 1999, issued its Order Appointing Hearing Examiner for the limited purpose of ruling on all discovery matters. On February 12, 1999, the Commission issued a Motion to Require Supplementation of Application or Other Relief.

### **Comments Filed**

Numerous public comments were filed regarding the merger. Most of the comments were in favor of the merger. However, most of the customers who filed comments in favor of the merger were GTE South customers who were under the impression that they would begin receiving BA-VA rates and service. Some commented on the poor and outdated service GTE South customers receive in southwestern Virginia. Other comments opposed the merger for various reasons. In addition to individual comments, the Telephone Resellers Association (“the TRA”) filed comments in the case, on December 15, 1998, as well. The TRA’s comments contained concerns regarding the public interest impact of the merger, but TRA did not oppose the merger itself.

MCI WorldCom, Inc., (“MCIW”) filed comments on January 7, 1999. In its comments, MCIW asked that the Commission deny the merger outright. MCI stated that should the Commission not reject the merger outright, the Commission should impose specific conditions on the merger that will promote local competition. MCIW stated that such conditions should be implemented prior to granting approval of the merger and that a hearing providing an opportunity to comment on such conditions would be necessary.

On January 7, 1999, Sprint Communications Company LP (“Sprint”) filed comments. In its comments, Sprint asked the Commission to dismiss the petition. In the alternative, Sprint stated that the Commission should deny the petition. Sprint also requested a hearing in order that a comprehensive evidentiary record might be developed to assist the Commission in making its decision.

AT&T Communications of Virginia, Inc. (“AT&T”) also filed its comments on January 7, 1999, in which AT&T opposed the petition and requested that the Commission

deny the petition. In the alternative, AT&T requested that the Commission hold hearings in which all issues identified in its comments may be investigated and resolved. In the event that the Commission did not hold hearings, AT&T requested an opportunity to supplement its comments once Bell Atlantic and GTE have complied with all information requests. AT&T filed supplemental comments on February 12, 1999.

Also on January 7, 1999, Starpower Communications, LLC (“Starpower”) filed its comments in opposition to the petition. In its comments, Starpower requested that the Commission deny the petition or institute an investigation into the proposed merger and assign the case to a hearing examiner for a hearing.

### **Discussion of Issues**

Section 56-88.1 of the Code of Virginia requires that the Commission approve any transfer of control of a telephone company operating in the Commonwealth of Virginia. Section 56-90 of the Code of Virginia requires that, in approving such transfer of control, the Commission must be assured that the transfer will neither impair nor jeopardize the provision of adequate service to the public at just and reasonable rates. In this petition, authority is requested for GTE to merge with Bell Atlantic and for GTE to exist as a wholly owned subsidiary of Bell Atlantic. The two parents of two Virginia utilities, BA-VA and GTE South will merge. Therefore, the transfer of control of GTE South will change, and it is this transfer that needs Commission approval under Chapter 5. There will be no change in control of BA-VA.

In reviewing whether the proposed transfer of control and merger will have any detrimental impact on the provision of telephone service to customers, the review and analysis is complicated by the fact that there are two regulated telephone companies

involved. Applications have been, or will be, filed in all fifty states. Out of all of the states that need to review the proposed merger, Virginia and Pennsylvania` are the only states in which both Bell Atlantic and GTE operate as incumbent local exchange carriers.

In reviewing the petition from the standpoint as to whether the merger would have an adverse impact on the provision of adequate service at just and reasonable rates, Staff requested additional information from BA-VA and GTE South, some of which should have been included in the original petition. The issues addressed in interrogatories attempted to obtain information that would provide concrete support that customers would be at least as well off in terms of rates and service as a result of the proposed merger, to determine the impact of the merger on market power, potential competition of BA-VA and GTE South in each other's service territory, and to determine whether the merger would remove a potential competitor. Petitioners also were asked whether removing a potential competitor would have any adverse impact on rates and service. Staff requested information on anticipated cost savings as a result of the merger and how such savings would be allocated between stockholders and ratepayers in Virginia. Staff requested explanations on various statements made in the petition in support of the merger. Staff also requested additional information on any anticipated pro-competitive benefits as well as any anti-competitive impacts, approvals required in other jurisdictions, impact of the merger on capital structures, access to financial and capital markets, and impacts on employee levels, facilities, and services in Virginia.

Most of the responses were vague and general with little or no specific information and support for statements made in the petition. This was especially true regarding issues related to competition and whether the merger would remove a potential

competitor in Virginia, and if so, what impact such removal would have on rates and services in Virginia. This merger involves the two largest telephone companies in Virginia, and there is concern that the merger would be anti-competitive and would have an impact on service and rates.

Responses from Petitioners, however, did not provide strong support that this would not be the case. Responses indicated that GTE does not currently offer competing local exchange service in BA-VA's franchise territories, and there are already more than fifty competitors authorized to do so. Petitioners further state that the addition or subtraction of GTE as an actual or potential competitor would not have any significance in terms of the competitiveness of the territories in which BA-VA provides local exchange service. In fact, BA-VA and GTE South indicate that they are not significant potential competitors in each other's territory. The issues were addressed from a national perspective in that the proposed merger would allow Bell Atlantic and GTE to better compete on a national and international level. The Division of Economics and Finance will address the issue of competition and the impact on the provision of service to customers at just and reasonable rates in more detail.

In addition to the ability to better compete on a national and international level, GTE and Bell Atlantic indicate that there will be annual expense savings of approximately \$2 billion and \$.5 billion in annual capital expenditure savings resulting from the merger. Petitioners indicate that this represents savings beyond what each entity could realize separately. Petitioners estimated that three years from the closing of the merger, the new company would achieve, on a continuing basis, \$2 billion more in revenues. However, when asked about the portion of those savings that will benefit

Virginia customers, Petitioners indicated that such information was not yet available, and that it depended on other factors such as customer demand and on Petitioners' competitive success in meeting those demands. Such benefits would not be known until some later date. However, similar information has been provided to other jurisdictions, such as the Illinois Commission.

The petition asserts that the capital structures of BA-VA and GTE South will not change as a result of the merger but that the merger will result in a larger, more efficient company with increased financial strength. No specific information was given to support these statements. The Division of Economics and Finance also will cover these issues.

In addition to the concern as to whether the merger will eliminate a competitor in each of Petitioner's territories and whether the lack of such competition will have an adverse impact on rates and service provided to customers in Virginia, there are concerns relative to the fact that BA-VA currently is prohibited from providing interLATA long distance telecommunications service by the FCC and whether this merger is a way of getting around that prohibition. There is also the concern regarding GTE South's Local Calling Plan ("GTE LCP"), which has interLATA routes, and what impact the merger will have on GTE LCP customers' rates and service. Many of these issues will be affected by decisions made by the FCC. The Communications Division will address these issues as well as other rates and service concerns.

From a ratemaking standpoint, GTE South and BA-VA are under different regulatory plans, which will be discussed later in this report. However, due to the fact Petitioners are under different regulatory plans, they have been treated differently regarding affiliate transactions. In Case No. PUA960044, by Order dated March 28,



1997, BA-VA was granted an exemption from filing for prior approval of its affiliate transactions. In Case No. PUA970043, GTE South was granted a limited exemption from filing for prior approval of its affiliate transactions based on the dollar amount of the transactions on a total contract basis and Virginia jurisdiction basis. The Order Granting Limited Exemption in this case was dated May 8, 1998. Unlike the exemption granted BA-VA, the limited exemption granted GTE South does not expire.

If the proposed merger between Bell Atlantic and GTE is approved, BA-VA and GTE South will become affiliates pursuant to Chapter 4 and will be subject to regulation under the Affiliates Act. However, as it currently stands, the two companies will be subject to different filing requirements as to prior approval as well as reporting requirements. Close monitoring of affiliate transactions between BA-VA and GTE South will be more challenging than if they were under the same affiliate requirements. However, no immediate changes should be made in the respective requirements.

As mentioned earlier, currently, BA-VA and GTE South are governed by two different regulatory plans. BA-VA is under what is considered a price index plan with no earnings regulation. Once the cap is lifted for a category of services, BA-VA has the authority to increase the rates of the services as long as the increase does not exceed a certain percentage limit. The caps have been removed for all services, except Basic Local Exchange Telephone Services ("BLETS"), where the cap will be lifted January 1, 2001. GTE South's plan calls for earnings regulation where overearnings are refunded to the customers, but no rates are changed. GTE South files Annual Informational Filings

(“AIFs”), which show intrastate tariffed earnings. If GTE South’s return on equity exceeds the range, calculated annually, then GTE South must make a refund to its customers. Because the two plans are fundamentally different, as one is earnings-based regulation and the other is not, there is every incentive for Petitioners to try and shift costs to GTE South. Staff believes that until GTE South requests, and is granted, a regulatory plan similar to BA-VA’s, the two companies must keep their operations separate. This will help to ensure that no cross subsidization will occur between the companies.

Another area of concern with Petitioners being governed by two different regulatory plans is the capital structure. The merger could have an impact on GTE South’s capital structure and affect earnings under its AIFs. This concern is more thoroughly addressed in the Economics and Finance section of this report.

Petitioners being regulated by two different plans is also a concern for any net savings arising from the merger. The net savings will be available for review for GTE South during the annual AIF process, but not for BA-VA. Currently, Petitioners have not quantified savings or costs on a Virginia jurisdictional basis. Because of this, if the merger is approved, Staff believes that Petitioners should be ordered to submit to the Commission, prior to the actual merger, a ten-year projection of costs and savings by company. Petitioners should be required to track the costs and savings for each company and submit to Staff, one year after the merger is consummated, a true-up to the ten-year projection of net savings for BA-VA and GTE South, if necessary. This may help to assure the Commission that the ratepayers are sharing in any net savings arising from the merger. Also, by tracking the costs and savings, the Commission will be able to

determine if any future rate increases for Petitioners are the direct result of merger costs without any merger savings, and have thus harmed reliable service at just and reasonable rates. Another reasonable condition to place on the merger approval would be to extend the cap on BA-VA's BLETS for at least eight years. This would be a benefit to BA-VA's ratepayers by locking in their rates for a longer period of time, thus helping to ensure that the merger will not impair these affordable rates. The costs will end in two to three years, but the savings, while theoretically continuing indefinitely, will take some time to realize.

Staff also has concerns about Petitioners' altering their costs of service by changing accounting policies to be consistent between the two companies. Staff attempted to get a list of all accounting policies that currently differed between the companies. Neither company was familiar enough with the other's booking practices to give Staff a list of current differences. However, GTE South stated that the accounting policies would be the same post-merger. A change in accounting principles could have a significant impact on a company's books. If GTE South made a change, it could be reviewed during an AIF proceeding and appropriate actions could be taken to address the change. However, if BA-VA made an accounting policy change, the Commission may not be aware of it through the annual monitoring that is required under BA-VA's alternative regulatory plan. Staff recommends that the Commission order BA-VA and GTE South to send appropriate notice of any accounting changes for either company, which includes the dollar impact of the accounting change, to the Division of Public Utility Accounting at least ninety days prior to the effective date. This is in accordance with Accounting Circular No. 21, sent to the Companies on September 30, 1987.

## **Recommendations**

Based on information contained in the petition and responses to interrogatories, Petitioners have not provided sufficient support that the proposed merger will not have an adverse impact on the provision of service to customers in Virginia at just and reasonable rates. For this reason, the Commission could conclude that the merger should not be approved. As an alternative, the Commission could, and Staff believes should, require Petitioners to share savings with their customers as a reasonable condition to approve the merger. Petitioners have not shown how anticipated net savings from the merger will benefit customers in Virginia. Petitioners, on February 4, 1999, announced a new Local Calling Plan designed to bring substantial customer benefits in the event the merger is completed. However, it is unclear at this point how much savings Virginia customers will actually reap as a result of this plan. Petitioners also have not adequately shown how they will deal with the prohibition against Bell Atlantic or its affiliates (including GTE South, if the companies merger) providing interLATA service. These problems need to be dealt with and specific solutions need to be arrived at to assure the Commission that the proposed merger will neither impair nor jeopardize the provision of adequate service to the public at just and reasonable rates.

As the petition currently exists, it does not appear that the merger meets the test of the Utility Transfers Act as referenced above. Until Petitioners can show that (1) no customers in Virginia will be harmed in terms of rates and service, and (2) GTE South's Local Calling Plan interLATA routes are maintained, the merger should not be approved. Once Petitioners have obtained the necessary decisions from the FCC and have more

information on cost savings for Virginia, then they could re-file for approval, or reconsideration, if done within the appropriate time frame.

The Commission, however, could approve the merger conditioned upon BA-VA and GTE South obtaining the necessary approvals or waivers from the FCC and subsequently providing this Commission with specific information that supports that at least half of Virginia jurisdictional savings directly benefit Virginia ratepayers and that no customers in Virginia will be harmed by the merger in terms of rates and service. This information should be provided before the merger actually takes place. As mentioned earlier, Petitioners should be required to track the actual costs and savings for each company and submit to Staff, prior to the merger being consummated, a ten-year projection of net savings for BA-VA and GTE South in Virginia. This projection should be trued-up using actual information one year after the merger has taken place. Also

BA-VA's rate cap on BLETS should be extended for at least eight years. The costs will end in two to three years, but the savings, while theoretically continuing indefinitely, will take some time to realize. BA-VA and GTE South also should be required to send appropriate notice of any accounting changes, which includes the dollar impact of the accounting change, to the Division of Public Utility Accounting at least ninety days prior to the effective date of such change. Concerning the Affiliates Act exemptions, no changes currently are recommended for GTE South as such exemption relates to its existing affiliates. It is recommended that BA-VA's current exemption be re-evaluated in light of the merger. However, any agreements between BA-VA and GTE South should be filed by both Petitioners for prior approval. Current exemptions should not include agreements and arrangements between BA-VA and GTE South

affiliates and agreements and arrangements between GTE South and BA-VA affiliates.

## **PART B: DIVISION OF ECONOMICS AND FINANCE**

### **FINANCIAL ANALYSIS**

This portion of the Staff Report addresses some of the financial aspects of the proposed merger between Bell Atlantic Corporation (“Bell Atlantic”) and GTE Corporation (“GTE”) (together referenced as “Petitioners”) as they relate to Petitioners’ respective subsidiaries, Bell Atlantic-Virginia (“BA-VA”) and GTE South Incorporated (“GTE South”). With BA-VA and GTE South being the two predominant providers of local exchange telephone service in Virginia, it is necessary to examine any financial ramifications of the proposed merger that might impair or jeopardize adequate service at just and reasonable rates. In addition, this section also explores some alternative recommendations that could be used to counter the threat that just and reasonable rates might be impaired by the proposed merger.

Under traditional rate of return regulation, the financial analysis of such a parent company merger would generally focus on issues that have a bearing on the overall cost of capital borne by ratepayers to support regulated telephone service by the operating subsidiaries. Issues of concern could include changes in capitalization ratios, changes in methods of financing, and changes in business risk that could impact the cost of debt and/or equity capital. These types of issues remain wholly relevant to GTE South in the present case because its Virginia jurisdictional operations remain subject to rate of return regulation under its Alternative Regulatory Plan. Without GTE in the equation, such issues would be of less significance to BA-VA, whose operations are subject to the price index structure under its Alternative Regulatory Plan. In this case, however, Bell Atlantic and GTE propose to merge while continuing to have BA-VA and GTE South provide

separate jurisdictional service under two fundamentally different regulatory plans. As discussed later, Staff is concerned that this framework could impair just and reasonable rates unless some measures are taken to counterbalance that threat.

### **Pre-Merger Financial Profile**

The tables presented in this section summarize some key measures of financial condition and performance for Bell Atlantic versus GTE and BA-VA versus GTE South. On a stand alone basis, Bell Atlantic and GTE are already heavyweight contenders in the world of diversified telecommunications companies as measured by total assets, total capital, cash flow and net income. Through a rash of pending/completed mergers, however, the industry is evolving into fewer, but larger, super-heavyweight telecom companies. These companies are rushing to marshal sufficient resources and strategic assets to become the first providers of a complete array of bundled telecommunications and related services. This type of company has been characterized as a “NeoBell” by Victor Schnee, author of *MegaStrategies: Winning the Computer-Telecom War*.<sup>1</sup> In the instant case, if the FCC grants approval of the proposed merger and permits Bell Atlantic’s entry into the long distance market, it would appear to position the post-merger Bell Atlantic near the head of the pack of telecom titans.

Bell Atlantic’s operations are geographically concentrated in the northeastern United States and include more densely populated, urban territory compared to the territory served by GTE. This factor has both positive and negative implications for Bell Atlantic. On the positive side, such territory can generally be served at a lower cost than more rural/suburban territory and it tends

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<sup>1</sup> Carol Wilson et al., “Bell Atlantic, GTE: Big Bell May Take Toll On Net”, Inter@ctive Week, August 3, 1998.



to offers more opportunities for revenue growth (e.g., higher concentration of prospects for discretionary services and second access lines along with more business prospects for “yellow page” advertising, Centrex lines and other business service needs). On the negative side, however, Bell Atlantic’s territory is generally more susceptible to competition because the positive aspects of its market are attractive incentives for increased competition. This factor presents a higher level of business risk to Bell Atlantic than GTE. However, investors and capital markets are more concerned with total risk, which is the combination of business and financial risk.

One broad measure of total risk is reflected by bond ratings. By this measure, GTE operations would appear to have marginally higher total risk than Bell Atlantic by virtue of its slightly lower bond ratings. Other factors indicative of GTE’s marginally higher risk profile include its higher leverage (debt ratio) and lower interest coverage. In addition, GTE’s Value Line ratings for safety and financial strength were lower than Bell Atlantic’s ratings until January of 1999 when they were upgraded after the merger process was underway.

<b>Financial Profile</b>		
<b>Debt Ratings</b>	<b>Bell Atlantic</b>	<b>GTE</b>
Senior Unsecured		
Standard & Poor's On CreditWatch –	A+ Negative	A Positive
Moody's Outlook	A1 Possible downgrade	Baa1 Possible upgrade
Commercial Paper		
Standard & Poor's	A-1	A-1
Moody's	P-1	P-2
<b>Value Line Measures (1/8/99 issue)</b>	<b>Bell Atlantic</b>	<b>GTE</b>
Beta	0.85	0.90
Safety Rank	1	1 (upgraded from 2 following merger announcement)
Financial Strength	A+	A+ (upgraded from A following merger announcement)
P/E Ratio	20.9	21.5
Dividend Yield (%)	2.7%	2.6%
Long-Term Debt Ratio (%)	39.8%	63.0%
Common Equity Ratio (%)	59.5%	37.0%
Total Capital (\$ in millions)	\$28,945	\$25,760
Market Capital (\$ in billions)	\$93.0	\$68.5
Total Interest Coverage	5.9x	5.1x
<b>Common Financial Measures (4th Quarter Statements from Company Websites)</b>	<b>Bell Atlantic</b>	<b>GTE</b>
Annual Dividend	1.54	1.88
Return on Equity (12/31/98)	32.8% (adj. earn.)	34.8%

As reflected by various measures in the table below, the financial profiles of BA-VA and GTE South are stronger than their respective parent companies. Similar to the posture of their respective parent companies, BA-VA appears to have a slightly stronger financial profile than GTE South. While GTE South operations have tended to be more leveraged than BA-VA, that has been offset to

some degree by GTE South's lower exposure to competitive pressures and business risk.

<b>Financial Profile</b>		
<b>Debt Ratings</b>	<b>Bell Atlantic-Virginia</b>	<b>GTE South.</b>
Standard & Poor's CreditWatch -	AA Negative	AA- Stable
Moody's Outlook -	Aa2 Possible downgrade	A1 Possible upgrade
<b>Common Financial Measures</b> (Standard & Poor's Global Utilities Rating Service Financial Statistics 06/30/98)	<b>Bell Atlantic-Virginia</b>	<b>GTE South.</b>
Long-Term Debt Ratio (%)	42.7%	54.0%
Common Equity Ratio (%)	49.6%	45.7%
Total Capitalization (Mil. \$)	\$2,215.6	\$1,482.7
Pre-Tax Interest Coverage	7.39x	8.73x
Return on Equity (%)	25.7%	43.1%
Net Cash Flow/Capital Expend. (%)	81.4%	71.8%
Common Dividend Payout (%)	89.1%	94.3%

### **Post-Merger Financial Profile**

Bell Atlantic's post-merger financial profile is expected to be somewhat weaker after absorbing the relatively weaker profile of GTE. This expectation is reflected in the comments of bond rating agencies that have indicated that the credit ratings of Bell Atlantic and its subsidiaries may be downgraded as a consequence of the merger. In a ratings announcement released on July 28, 1998, Moody's Investors Service ("Moody's") stated:

The review for downgrade of BAC (Bell Atlantic Corporation) reflects the weakening in cash flow credit measures for the new consolidated enterprise that will likely result from the transaction.

On the other hand, bond rating agencies have indicated that GTE's credit ratings may be upgraded as a consequence of its prospective merger with the stronger Bell Atlantic.

Even if the proposed merger is not consummated, the financial profiles of BA-VA and GTE South would likely follow the general weakening trend in the evolving telecommunications industry according to credit analysts at Moody's. In a ratings press release dated October 6, 1998, Moody's stated:

In general, holding companies' trend [sic] to manage their telephone operating companies as a unit and the accelerating industry trends toward consolidation and diversification are expanding the number of companies under a single corporate umbrella and increasing the possibility of cross-subsidization of subsidiaries that are deemed to be strategic.

Moody's goes on to state that:

Like diversification efforts of the past, which were oriented primarily toward non-strategic, financial investments, today's investments possess higher risk characteristics and are often highly leveraged. These factors combine to pressure the credit risk profile of the consolidated entity.

However, unlike the past, today's investments are often viewed as essential services by companies positioning themselves as total communications providers. This assessment makes it increasingly likely that they would not walk away in a time of stress and make it more likely that the parent would tap the telephone operating subsidiaries for financial support

Given that they each seek to become a leading one-stop provider of diverse telecommunication services, it seems very likely that Bell Atlantic and GTE would consider another prospective merger to attain the resources necessary to achieve that goal if their pending merger does not go through.

From a Virginia regulatory perspective, the most critical aspect of a Bell Atlantic/GTE merger is the potential impact it could have on BA-VA's and GTE South's cost of, and access to, capital. Petitioners have stated that they intend to maintain and operate the local exchange subsidiaries of GTE and Bell Atlantic as separate companies. Presently these companies finance debt on a stand alone basis and maintain separate credit ratings. With the debt ratings between BA-VA and GTE South separated by only one rating category, any short-term impact of the merger on interest rates for new debt is likely to be negligible. Since most of BA-VA and GTE South's 1999 capital expenditures are expected to be financed with internally generated funds, any new debt is more likely to be issued for the purpose of refunding of higher cost debt, given the current interest rate environment.<sup>2</sup>

While more difficult to assess, the greatest concern from the merger is the potential threat it poses to maintaining the long-term strength of BA-VA's or GTE South's capital structure and their ability to attract capital. Their respective financial profiles will depend to a great extent on the financial stress or relief provided by Petitioners' increased investment in unregulated, competitive operations. In a worst case scenario, competitive pressures could begin to seriously impair the establishment and profitability of Petitioner's unregulated ventures. This would increase the pressure to have the operating subsidiaries pay more dividends than earnings to the parent company to support competitive operations. In conjunction, the focus on competitive ventures could provide a disincentive to restore operating company equity ratios through investing more equity capital because such capital is deemed more critical to supporting competitive operations. Over time, if too much of BA-VA's and GTE South's

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<sup>2</sup> 1999 Annual Financing Plans filed with the Division of Economics and Finance by Bell Atlantic-Virginia and GTE South.

internally generated cash is siphoned away and equity capital is not forthcoming from BA, the operating companies might need to access external funds from the capital market in a weaker state of credit quality. Presently, this would not impact BA-VA's customers until 2001 when basic rates may be indexed up annually, as specified in BA-VA's alternative regulatory plan. Under GTE South's regulatory plan, however, higher interest rates could lead it to a request for a rate increase to recover higher costs at any time.

As previously discussed, bond analysts have already factored the potential for cross-subsidization into their bond ratings and have in many cases downgraded or mentioned the possible downgrade of telephone operating company bond ratings. This action is evidence that the potential for cross-subsidization poses another threat to credit quality and rates. Under a less drastic cross-subsidization scenario, the regulated operations of GTE South could be earning above their authorized range, yet to avoid a refund, some unregulated costs are shifted to reduce regulated earnings within the range. In addition to avoiding a refund, such action would help unregulated operations appear less costly and more profitable. Under its regulatory plan, BA-VA is not subject to rate of return regulation and the associated potential for refunds. Instead, BA-VA's basic service rates are frozen until January 1, 2001, when they may then be increased annually on a percentage basis by no more than one-half of the prior years increase in the Gross Domestic Product Price Index. Assuming that BA-VA's alternatively regulated operations repeatedly earn high returns, customers would find it hard to quietly accept indexed rate increases when earnings appear more than adequate for noncompetitive services. Under BA-VA's Alternative Regulatory Plan, a protest or objection to a basic rate increase filed by twenty or more customers can initiate a public hearing concerning the lawfulness of the increase. As with GTE South,

BA-VA may have the temptation and incentive to shift enough costs to make a rate increase appear justified for basic services while lowering the cost of competitive operations.

### **Merger Dynamics**

Based on reports by financial and technology analysts, there are four main factors that appear to be the impetus for the proposed merger. First, and perhaps foremost is the “marriage” of GTE’s data services infrastructure with the huge market of data hungry customers in Bell Atlantic’s territory. A July 29, 1998, investment analyst report by Nationsbank Montgomery Securities stated that:

In short, this is a data services-driven combination that should allow both firms to enhance shareholder value as they deliver a compelling package of easy to use bandwidth upgrades to a combined user base of 63 million customers (the largest in the industry).

A report by Credit Suisse First Boston indicates that the company projects revenues from data service operations to account for approximately half of the \$2 billion of revenue synergies expected from the merger.<sup>3</sup>

A second strategic factor for the merger is the acquisition of GTE’s long distance operations and the possible segue that it gives Bell Atlantic to providing long distance service. The previously noted analyst’s report from First Boston indicates that Petitioners project long distance revenues to account for approximately \$0.8 billion of the projected \$2 billion in revenue synergies from the merger.

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<sup>3</sup> Additional proprietary information on importance of data services attached in confidential addendum to Staff Report.

The third factor appears to be size. Petitioners note in their application that the merger will produce an entity with the “scale and scope” of capital and other resources to compete effectively against other merging telecommunications entities as noted in their application (AT&T/TCG/TCI/British Telecom, WorldCom/MCI/MFS/UUNET, and SBC/PACTEL/SNET/Ameritech). In addition to deeper pockets, this merger would give Bell Atlantic a much larger market presence outside of its traditional northeast/mid-Atlantic territory.

The fourth and equally important factor would be the estimated \$2 billion per year of expense related savings and \$500 million of annual capital related savings that Petitioners expect to result from the merger.

### **Staff Concerns**

From a Virginia jurisdictional perspective, Staff has several concerns with certain aspects of the merger as proposed. As recognized by bond rating agencies, Staff is very concerned by the cross-subsidization threat posed by the merger. In this particular case, the threat appears to be exacerbated by the fact that 1) GTE South will continue under rate of return regulation while BA-VA will continue under its price index plan and 2) BA-VA presently has total exemption while GTE South has limited exemption (below \$250,000 on a Virginia jurisdictional basis) from obtaining prior approval for affiliate transactions.<sup>4</sup> It appears that the merger is being predominately driven by the quest for competitive assets and opportunities. With the implicit emphasis on the success of these operations, any shifting of costs to or within GTE South could jeopardize reasonable rates and any

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<sup>4</sup> Application of Bell Atlantic-Virginia, Inc., For exemptions under § 56-77(B) of the Code of Virginia, Case No. PUA960044, Final Order dated March 28, 1997; and Application of GTE South Incorporated, For a limited exemption under Chapter 4, Title 56, of the Code of Virginia, Case No. PUA970043, Final Order dated May 8, 1998.



future refunds otherwise due GTE South customers under its alternative regulatory plan.

From a public interest perspective, Staff is also concerned that Petitioners neither offer nor support any up-front tangible benefits to Virginia customers as a consequence of the proposed merger. Petitioners have announced plans to expand local calling areas if the merger is approved. Purportedly, this action would cost Petitioners some \$20 million in lost toll revenues. However, Staff cannot yet substantiate the validity of that claim since Petitioners have not filed specific information regarding those plans. In general, Petitioners' plans for expanded calling areas reflect the type of benefit that would be in the public interest and benefit their Virginia consumers. However, such benefits are far from tangible given that Petitioners have stated that such calling area expansion would only be completed some 18 months after the merger is closed.

With respect to up-front tangible benefits to ratepayers, Staff notes that in two recent cases approving mergers for energy utilities in Virginia, the merging companies included proposals in their respective applications for an up-front sharing of estimated merger related savings with customers.<sup>5</sup> These energy companies were also looking to expand the scale and scope of their operations and to direct resources into more competitive, unregulated business operations, including telecommunications. It is also worth noting that the two energy companies involved in mergers have operations and customers in Virginia territories that are presently served by Bell Atlantic. It only seems reasonable that

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<sup>5</sup> Application of Delmarva Power and Light Company and Conectiv, Inc., For approvals under Va. Code § 56-88.1 and Chapter 4 of Title 56 of the Code of Virginia, Case No. PUA970008, Commission Order dated August 6, 1997, and; Petition of Kentucky Utilities Company; d/b/a Old Dominion Power Company, KU Energy Corporation and LG&E Energy Corp., For approval of the acquisition and control of Kentucky Utilities Company by LG&E Energy Corp., Case No. PUA970041; Commission Order dated January 20, 1988.

those customers would expect some tangible form of benefit related to Petitioners' proposed merger given the savings synergies reported. When asked to quantify the Virginia specific savings expected from the merger, Petitioners only responded that "No determination has been made as to the exact extent of such savings specifically in Virginia."<sup>6</sup> Yet in the testimony filed in Illinois for the Petitioners' merger, GTE provided a jurisdictional net savings figure.

This is not to say that Petitioners should provide a specific sharing of merger related cost savings only through an explicit refund or rate reduction. Instead, other significant benefits could be gained by establishing GTE South's class service offerings at parity with BA-VA and by expanding local calling areas as discussed by the Division of Communications. In addition to being consistent with the public interest, establishing parity of class service offerings would also support Petitioners' claim that a benefit of the proposed merger is to assure their ability to accelerate deployment of advanced services to customers. Petitioners could also work with Staff to expedite the offering of extended/integrated calling areas among Petitioners' customers.

### **Recommendations**

It is Staff's position that the application as filed by the Petitioners is not sufficient to support approval of the proposed merger. Staff recommends that the Commission should consider certain conditions that would mitigate the threat of cross-subsidization and balance ratepayer interest with shareholder interest before approving a BA/GTE merger.

With such fundamentally different regulatory plans and different affiliate arrangements, the close monitoring of new affiliate transactions between GTE

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<sup>6</sup> Responses dated November 28, 1998, to Interrogatory 6 of Staff's First Set of Interrogatories.

South and Bell Atlantic affiliates is particularly critical to mitigating the threat of any cross-subsidization. Staff recommends that any transactions between GTE South and Bell Atlantic affiliates and transactions between BA-VA and GTE affiliates be subject to the prior notice and approval requirements of the affiliate statutes.

Another measure to mitigate the threat of cross-subsidization and provide a tangible benefit to BA-VA ratepayers would be to extend the freeze on basic service rates for an extended period.

In regard to balancing the interest of ratepayers with shareholders, other tangible benefit(s), such as class service parity and extended calling areas, should be considered as soon as feasible after the merger closes.

## **ECONOMIC ANALYSIS**

### **Market Power**

In the comments received regarding the proposed merger of Bell Atlantic and GTE, several parties have argued that the merger will bring about increased market power. At this time there is no widely available, facilities-based, competitive alternative for local telephone service to residential and/or business customers across Virginia, even though there are 76 certificated competitive local exchange carriers (CLECs) in Virginia. Based upon the most recent Staff estimates of competitive local exchange activity in Virginia, incumbent local exchange carriers (ILECs) have a 99.1% market share, based upon the number of access lines. Only a portion of this competition is facilities-based. Resale competition does not represent effective local exchange competition, which is necessary to constrain monopoly power. At a minimum, effective local exchange competitors will have the ability to price competitively, based upon their own costs. Resale competition relies upon the incumbent's network for the provision of services and, therefore, the competitor can only price its service based upon the price it pays the incumbent. Each ILEC in Virginia, including BA-VA and GTE South, remains the sole ubiquitous provider of local exchange service in its territory and as such retains effectively complete market power.

A market concentration ratio, such as the Herfindahl index (HHI), is frequently used as a measure of market power. However, the HHI is not readily

affected by market shares of 1% or less. Staff does not calculate an HHI for the Virginia local market, as it did for the Virginia long distance market for many years, because the market shares at this time are not sufficient to reflect any appreciable change to the index.<sup>7</sup>

### **Anti-Competitive**

Petitioners maintain, at page 15-16 of their application, that the loss of one potential competitor in Virginia is “not competitively significant.” Staff disagrees. On a more general level the loss of one potential competitor, out of a seemingly unlimited pool, might not be a significant threat to the potential for local competition in Virginia. However, the loss of GTE South and BA-VA as potential competitors to one another in Virginia is significant. The two companies represent the most geographically well-situated competitor against one another in Virginia and the most qualified competitor as an ILEC, in a financial, managerial and technical sense.

AT&T’s Supplemental Comments, filed on February 12, 1999, document the extent to which both Bell Atlantic<sup>8</sup> and GTE<sup>9</sup> seriously studied the potential for entry into one another’s territory. GTECC filed an application for CLEC authority in its own territory and that of BA-VA in Virginia but withdrew this application just prior to the merger application.

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<sup>7</sup> The Herfindahl index is calculated by summing the squared market shares of all participants. Market shares as low as 1% (.01) or less, when squared  $.01 \times .01 = .0001$ , will have no effect on the index when added to the squared market shares of the incumbents, until 50 or more participants have market shares of at least 1%.

<sup>8</sup> AT&T’s February 12, 1999, “Supplemental Comments”, pg. 6.

<sup>9</sup> Id., pg. 10.

The Petitioners' merger application at the FCC justifies the merger through enabling the combined company to use GTE's extant territory as a base from which to "attack the local markets of other Bell companies on a widespread and effective"<sup>10</sup> basis. This very rationale is the reason that the merger is anti-competitive for Virginia. GTE South would have used its own facilities in Virginia, contiguous to many BA-VA territories, as a stepping stone into BA-VA territories. BA-VA would have done the same with GTE South territories.

The merger is anti-competitive in Virginia and as such poses a potential threat to maintaining just and reasonable rates as required by Section 56-90. The Telecommunications Act of 1996 (the Act) explicitly requires competition. Section 56-265.4:4 C 3 of the Code of Virginia mandates a competitive local exchange market through its wording directing the Commission "to promote and seek to assure the provision of competitive services". Historically, rate regulation of local telephone companies and other monopolists provided a substitute for the constraining effect of competition on rates. With federal and state laws that mandate competition, the elimination of key potential competitors in Virginia poses a significant threat to the competitive market, the market that will be expected to constrain rates in the future, keeping rates just and reasonable.

The Commission should not approve the merger between BA and GTE unless the anti-competitive threat to rates can be mitigated. Petitioners should be required to individually report specific data to Staff regarding the CLECs that each

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<sup>10</sup> FCC Docket No. 98-184, In the Matter of GTE Corporation, Transferor, and Bell Atlantic Corporation, Transferee, For Consent to Transfer Control, October 2, 1998, pg. 6.

is interconnecting with and/or providing resold lines to, as evidence of the change in the market. This data could be provided through the same or similar report as was provided by BA-VA in response to Staff Interrogatory 7, First Set.

Tracking and monitoring of GTE South's costs and savings in Virginia from the merger through the AIF process could mitigate the anti-competitive threat to basic rates. An eight-year extension of the moratorium on basic local rate increases in BA-VA territories could serve to mitigate the anti-competitive effect of the merger on BA-VA's rates. Eight years will encompass the three years projected by Petitioners for the net savings to accrue and a reasonable period of five years to benefit ratepayers. During this period, effective competition may arise from other entrants.

In the event that the competitive market in Virginia develops such that it is an effective regulator of the price of a service, BA-VA, as well as GTE South, has the opportunity to request that that service be reclassified from the basic category to the competitive category. Under that scenario an extended rate cap would no longer apply to the reclassified service because the competitive market would be acting to constrain rates.

## **PART C: DIVISION OF COMMUNICATIONS**

This section of the Staff Report prepared by the Division of Communications will discuss the potential impact on rates and service quality that may result from the merger of GTE and Bell Atlantic. First this section will describe the expectations of Virginia consumers and the Staff's resulting concerns with respect to this proposed merger. Secondly, the report will address the Petitioners' proposed best practice policy and its possible impact on service quality. Finally, the report will address the Staff's concerns regarding interLATA services presently provided by GTE in Virginia.

### **Customer Expectations**

No doubt, this merger would result in the control of about 90% of the access lines in Virginia falling to Bell Atlantic, as the new parent company. However, the proposed merger would not combine the separate operating companies of Bell Atlantic and GTE that exist in Virginia today. Therefore, existing customers of BA-VA would remain as customers of BA-VA and customers of GTE South would still be served by that company.

It is this continuation of operations by BA-VA and GTE South as separate entities which raises some unique concerns involving customers' perceptions of the possible benefits of this merger. To understand this issue more clearly one needs to recognize the geographic relationship between GTE South exchanges and BA-VA exchanges. In many instances, GTE South exchanges surround the more metropolitan areas served by BA-



VA. As a result of this phenomenon, there are many GTE South customers who presently compare and contrast their rates and services to those available in nearby BA-VA service areas.<sup>1</sup>

This issue is of particular importance because, in spite of the public announcement of the Petitioners to continue as separate entities in Virginia, a number of consumers (primarily those served by GTE South) have expressed support for the merger based on their perception that they will either be served by BA-VA or the merger will bring “equality” of rates and services to those provided by BA-VA.

The Staff is not suggesting the Commission condition approval based on combining the operating companies in the State. However, there are several areas in which both the Petitioners and/or the Commission could readily look to realize additional benefits to consumers in Virginia, and in particular to those customers presently served by GTE South.<sup>2</sup>

Those involve the most significant areas where GTE South customers do not perceive they are being provided services at comparable levels to those provided to BA-VA customers. These areas are: (1) local calling areas; (2) local exchange rates; (3) availability of services; and (4) customer service.

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<sup>1</sup> This comparison of rates/services to BA-VA was also the subject of many of the consumer comments in GTE South’s most recent rate case in PUC950019.

<sup>2</sup> While, the Petitioners may argue additional benefits are not necessary to approve the merger under the standards of § 56-90, the Staff believes that the disparity between rates and services of two newly affiliated companies is a concern, particularly if cost savings will result from the proposed merger.

## **1. Calling Areas**

In general, GTE South customers have relatively small local calling areas in Virginia, particularly when compared to nearby BA-VA exchanges. This is a significant concern to many GTE South customers especially when they believe, for various reasons, their community of interests and calling needs are similar to those consumers in neighboring BA-VA exchanges. As mentioned earlier, this was also a major customer concern in GTE South's rate case (PUC950019) and was a principal factor in the Staff's recommendation to implement the subsequently approved Local Calling Plan ("GTE LCP").<sup>3</sup> The availability of the GTE LCP to customers in over three fourths of GTE South exchanges has gone a long way in providing "comparable" expanded calling on an optional basis although in many circumstances at considerably higher rates than for traditional local calling in the nearby BA-VA exchanges.

## **2. Local Exchange Rates**

The disparity between the rates of GTE South and BA-VA are certainly not limited to local exchange rates. The differences are as extensive as there are available services, ranging from access charges to ISDN. Without a doubt, the continuation of such disparities (and the potential introduction of new ones) in rates and structure between GTE South and BA-VA will raise and prolong concerns from various classes of customers which the Commission will ultimately be required to address. However, the

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<sup>3</sup> GTE South did propose extensive expanded non-optional local calling areas in its rate case. However, it was the Staff's position in that case that the Company's proposal did not encompass all its customers' needs and would have resulted in substantial rate increases for all customers, even those not getting increased calling.

Staff has only focused here on local exchange rates as they relate to customers' overall perceptions of the proposed merger. This issue again involves GTE South customers' view of "comparable" BA-VA rates. To a large extent this is related to comparable local calling areas discussed previously. A comparison may involve the difference between a GTE LCP rate in a GTE South exchange and a nearby BA-VA local rate which has similar extended local calling at a "lower" non-optional flat rate.<sup>4</sup>

However, there are additional comparisons to consider in order to better understand consumer concerns. Overall, the flat rates for residential local service are relatively comparable between GTE South and BA-VA when one looks at rate group levels.<sup>5</sup> However, that is not the case for GTE South's customers in its Southwest exchanges. The local exchange rates in these exchanges are significantly higher than those in nearby BA-VA exchanges with comparable-sized calling areas.<sup>6</sup> The disparity between rates for similarly situated customers in Southwest Virginia will certainly become less defensible and understandable to customers if the merger between BA and GTE takes place.

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<sup>4</sup> As an example, a residential customer in GTE South's Franklin exchange would have to pay \$33.00 a month to obtain unlimited flat rate calling to Norfolk/VA Beach/Portsmouth (as well as 18 additional exchanges). However a BA-VA residential customer in Norfolk/VA Beach would pay only \$13.59 for calling in a comparable (but somewhat less) area.

<sup>5</sup> However, the rates for business customer are generally higher for BA-VA than GTE South customers.

<sup>6</sup> As an example, the residential flat rate for GTE South's Big Prater exchange is \$15.05 a month while the nearby comparably sized exchange of Davenport (BA-VA) is \$11.57.

### **3. Availability of Services**

Another area in which GTE South customers often compare service to BA-VA's is the availability of advanced services. Of particular concern to the Staff is the disparity in the availability of Class services.<sup>7</sup> BA-VA offers Class services to all its customers in Virginia. GTE South does not. Exhibit Com – 1 is GTE South's responses to the Staff's Tenth Set of Interrogatories which provides GTE South's present and future deployment of Class services in its Virginia exchanges. This exhibit shows that GTE South plans to further deploy Class services in a large number of exchanges by June 30, 1999. This would greatly expand the availability of Class services to GTE South customers. The Staff is encouraged by GTE South's efforts but is also disappointed the company does not plan to offer Class services to all of its customers (primarily to those in the Southwest) until the year 2004. Again, if the merger takes place, it will be even more difficult to explain this disparity to GTE South customers without Class services when they know these services are available in neighboring BA-VA exchanges as well as other GTE South exchanges.

### **4. Customer Service**

A further area where GTE South customers compare service to BA-VA is that of customer service. This concern primarily involves GTE South's business office operations. This is a very critical service function for any company. Customer

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<sup>7</sup> Class services include such custom calling offerings as Caller ID, Call Trace, Call Return, Call Block, etc.

perception of a company's professionalism and interest in providing excellent service depends, in large part, on business office contacts being handled properly.

During the GTE South rate case, the Commission received numerous complaints from that company's customers concerning receiving incorrect information, and being treated in a discourteous manner by business office representatives. The Staff performed an on-site operational review and found that the complaints were valid. The service representatives were not well trained on the status of the rate case, local calling areas in Virginia, and rates in general. The representatives did not project a friendly or helpful attitude toward Virginia customers. In comparison, the Staff recently reviewed BA-VA's business office operations and found that the representatives were well trained with good attitudes enabling them to efficiently and effectively handle customer needs.

With respect to the four areas of customer expectations discussed above, the Staff cannot specifically conclude that "adequate service to the public at just and reasonable rates" would be impaired or jeopardized as an immediate result of the merger. The rates and provision of services of both operating companies in Virginia would remain the same (with one important possible exception to be discussed later). However, we do know that many current GTE South customers are expecting improved service as a result of this merger. This does not seem to be an unreasonable expectation, and to the extent there are cost savings and other synergies resulting from the proposed merger of Bell Atlantic and GTE, consumers in Virginia should benefit. Until recently, the Petitioners had not offered any quantifiable benefit to Virginians from the proposed merger.

However, on February 4, 1999, BA-VA and GTE South announced a plan to expand local calling for many customers in Virginia to take place approximately 18 months after completion of the merger. According to their press release, the Petitioners propose to implement a contiguous calling plan between and among the exchanges of BA-VA and GTE South.<sup>8</sup> The Petitioners estimate the calling plan would reduce revenues by more than \$20 million annually.

The Staff does not intend to evaluate the merits of this announced calling plan in this case as any such plan would need to be filed, noticed to the public, and approved in accordance with § 56-484.3. However, the Staff will briefly comment on the calling plan as it relates to previous discussions of local calling areas and local exchange rates.

The calling plan would provide additional flat rate calling to many BA-VA and GTE South customers, and many of those customers would likely benefit. However, a contiguous expansion would not for the most part result in the calling areas of GTE South customers closely “matching” those in neighboring BA-VA exchanges.<sup>9</sup> This is the case as customers in certain GTE South exchanges would only gain the ability to call the nearby, contiguous BA-VA exchanges as a local call but would not automatically obtain the entire local calling area of those contiguous BA-VA exchanges.

In addition, it is not likely this plan will always address expansion of service for the routes with the highest community of interest for a particular exchange. As an

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<sup>8</sup> BA-VA introduced a contiguous calling plan among its own exchanges several years ago.

<sup>9</sup> There are some exceptions, particularly for GTE South exchanges in the Tidewater area where the proposal is more expansive than contiguous.

example, based on usage information provided in GTE South's rate case, the community of interest between GTE South's Appomattox exchange and BA-VA's Lynchburg exchange is very high. However, because these exchanges are not contiguous, Appomattox would not be offered flat rate calling to Lynchburg. Instead, Appomattox would get calling to two contiguous exchanges (Concord and Gladstone) where the community of interest is not nearly as strong.<sup>10</sup> Another area of customer concern is likely to develop in GTE South's Northern Virginia exchanges which would get expanded flat rate calling to most of Northern Virginia, including some non-contiguous exchanges. However, unlike BA-VA's Northern Virginia exchanges, the GTE South exchanges would not get flat rate calling to the District of Columbia and suburban Maryland.

With respect to rates, if the calling plan is approved for any exchange it may result in a rate increase for an individual exchange due to rate regrouping. The Staff does not necessarily find fault with this provision, however, we believe it will be imperative that consumers receive adequate notice and opportunity to comment as the rate increases in a number of exchanges are substantial.<sup>11</sup>

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<sup>10</sup> Today, Appomattox customers can call Lynchburg on a flat rate basis if they purchase either Option 2 or 3 of the GTE LCP.

<sup>11</sup> As an example, residential customers in GTE South's Windsor exchange would get greatly expanded calling but would see the monthly flat rate increase from \$8.69 to \$15.45, due to being reclassified from Rate Group 1 to Rate Group 10. Business customers' increases would be even larger.

### **Best Practices Policy**

The next area of concern relates to the possible impact of the merger on the quality of service provided by both BA-VA and GTE South to their customers in Virginia. The Staff has previously discussed its concern regarding customer service, particularly for GTE South customers.

The Petitioners have stated that, while they intend to continue to provide service as separate entities in Virginia, there is the possibility of consolidating functions within those separate entities. Specifically, the Petitioners note they have adopted a “best practices” policy which will identify those practices across the two companies and the manner in which they will be implemented. However, the identification of these best practices is not yet available because it is under review by the Petitioners’ Merger Integration Teams.

The intent of combining the best practices of the Petitioners is to achieve savings and other operational benefits and efficiencies. These are certainly laudable and acceptable goals when two companies merge. However, the Staff is unable to determine whether any of these best practices (since they are not yet identified) are or will be beneficial to consumers in Virginia. In fact, there is also the possibility that the implementation of a “perceived” best practice from one company to the operations of the other company in Virginia could actually result in a lesser (although not necessarily sub-standard) quality of service being provided to customers. As an example, if the Petitioners decided that a best practice was to consolidate business offices and provide



this service as presently offered by GTE South, the Staff would consider that this could result in customer service being impaired for BA-VA customers.

### **InterLATA Services**

The Staff believes the most critical issue impacting the proposed merger is the ability of GTE Corporation to continue to provide certain interLATA services to customers in Virginia. There are two types of interLATA services provided by GTE affiliates in Virginia.

The first is long distance service provided by GTECC. Presently, GTECC offers both inter and intrastate (including interLATA) long distance services to consumers in Virginia. Under the Telecommunications Act of 1996 (“Act”), it will be necessary for Bell Atlantic to obtain § 271 approval or other relief from the FCC in order to continue providing such interLATA service if the merger is consummated.

To the extent § 271 or other relief has not been granted, at that time, it may be necessary for GTECC to discontinue providing interLATA long distance service to customers in Virginia.<sup>12</sup> This result would be of concern to the Staff as we believe it is in the best interests of consumers to be able to pick their carrier of choice.<sup>13</sup> However, as long as GTECC’s customers are given adequate time to choose another carrier, the Staff does not believe this would be an impairment to adequate service at just and reasonable rates. This is the case for two reasons. The first is that GTECC operates in the

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<sup>12</sup> Confidential footnote, see Confidential Addendum.

<sup>13</sup> Confidential footnote, see Confidential Addendum.

competitive long distance environment where customers have the choice of many carriers and rates. In addition, this Commission does not regulate GTECC as it is a long distance reseller. It would not seem reasonable to require the continuation of service by GTECC in Virginia as a condition for approval of the merger when GTECC is not currently subject to the regulation of this Commission.

The second type of interLATA service provided by a GTE affiliate to its customers, however, is another, more serious, matter. GTE South currently provides interLATA service in Virginia to many of its customers in conjunction with the GTE LCP.

As previously discussed, the Commission approved the GTE LCP in PUC950019. The LCP is an optional extended calling plan which was introduced to satisfy a wide variety of customer calling patterns and needs, ranging from those who wanted nothing more than to retain calling within their existing calling areas to those who chose a more expensive flat rate, unlimited service to avoid paying long distance toll rates to a number of nearby exchanges.<sup>14</sup> The GTE LCP<sup>15</sup> involves 81 exchanges and over 900 routes. Each LCP exchange has a set of expanded local calling routes which normally range from about a minimum of five to over fifteen routes which are available for calling on a seven digit dialed basis. The vast majority of these routes are intraLATA. However, there are

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<sup>14</sup> The GTE LCP was implemented in three phases in Virginia beginning in January 1998 and completed in July 1998.

<sup>15</sup> The GTE LCP consists of three options. Option 1 includes a fully measured offering to a number of exchanges. Option 2 provides flat rate service to some exchanges and measured to others. The third option is an unlimited flat rate service to all exchanges in that exchange's LCP area. Customers who desire none of these options retain their existing calling privileges and rates.

78 routes initiated from 37 exchanges which are interLATA in nature. Presently, about 33,000 GTE South customers are purchasing an LCP option that has at least one interLATA route.<sup>16</sup>

As mentioned previously, GTE South would not be permitted to continue offering these interLATA LCP routes post merger if Bell Atlantic has not received § 271 authority<sup>17</sup> or some other form of relief from the FCC. The Staff's Motion filed on February 12, 1999, describes this situation in greater detail and presents the Staff's position regarding proceeding with this case without first obtaining FCC approval or some other assurance that these routes may be continued.

Most importantly, the Staff is convinced that the GTE LCP interLATA routes must not be discontinued if the merger is approved by this Commission. To do otherwise would directly violate the standards of Code § 56-90 that "adequate service to the public at just and reasonable rates will not be impaired or jeopardized." If GTE South customers subscribing to the GTE LCP are no longer able to complete these interLATA calls, their service would be jeopardized and rates would be impaired.

### **Recommendations**

The Staff has raised a number of concerns regarding the rates and services that the Petitioners would provide if the merger takes place. It is the Staff's position that the

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<sup>16</sup> According to GTE South's updated response to a Staff's interrogatory filed on February 12, 1999, it does not believe it will be required to obtain FCC relief for all these interLATA routes based on its reading of the definition of a LATA in the Act. The Staff takes no position on the correct definition.

<sup>17</sup> If § 271 relief is granted, the Staff believes BA would still need some other FCC authority to provide this LCP service outside of the separate affiliate requirements of §272 of the Act.

Commission should not approve the merger between Bell Atlantic and GTE unless it is satisfied that the GTE LCP interLATA routes will be maintained. Assuming this critical condition can be met by the Petitioners and if the Commission finds that additional benefits to Virginia consumers should be required in conjunction with approval of the merger, the Staff has the following recommendations for the Commission's consideration:

(1) The BA-VA and GTE South announced calling plan of February 4, 1999, be subject to a separate proceeding and the Petitioners be required to look beyond contiguous exchanges in order to incorporate additional calling between exchanges with high communities of interest.

(2) The local service rates for GTE South's Southwest exchanges should be reduced to more accurately reflect those in nearby comparably sized BA-VA exchanges.

(3) All Class services should be available to all customers in GTE South exchanges by a date certain of no later than one year from the effective date of the merger of Bell Atlantic and GTE.

(4) BA-VA should not be permitted to consolidate its Virginia business office operations in Virginia with those of GTE or move them outside of Virginia without Commission approval. In addition, the Petitioners should be encouraged to develop a plan to handle all business office inquiries for both BA-VA and GTE South customers in a manner consistent with current BA-VA practices.